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STATE TAX PROBLEMS

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STATE TAX PROBLEMS

A LONG-POSTPONED DAY of fiscal reckoning has arrived for many states of the American Union. During most of the years since World War II, the great majority of state governments have lived beyond their income. Despite rounds of tax-raising in 1947, 1951, and 1955, the increase in state tax receipts has lagged substantially behind the rise in state outlays. In 1958, the revenues from all sources of all the states were not sufficient to cover the year's total expenditures.

Between 1946 and 1958,[1] state tax revenues climbed from $4.9 billion to $14.9 billion, an increase of 204 per cent, while over-all expenditures (including payments to local governments) were rising from $7 billion to $28.1 billion, a jump of 314 per cent. The deficits which might otherwise have resulted were covered in part by surpluses piled up during and immediately after the war, when opportunities for expenditure were severely restricted. The remainder of the gap was closed chiefly by borrowing. Long-term indebtedness of the states soared 556 per cent between 1946 and 1958, from $2.3 billion to $15.1 billion.

Since completion of the initial drive to catch up on war-delayed improvements, the bulk of state debt has not been contracted on behalf of projects ordinarily financed by bonds backed by the general credit of the state; it has been contracted for the kind of projects which can be financed by borrowing secured by the proceeds of particular taxes or other specific forms of revenue.

In theory, and in many cases by express constitutional command, the states remain committed to the pay-as-you-go principle. While there is considerable support for the proposition that some forms of public investment may justifiably be made in anticipation of future growth, no state leader has been willing to undertake the arduous and politically hazardous campaign that would be needed to remove

[1] Bureau of the Census, U.S. Department of Commerce, *Summary of State Government Finances in 1958*, issued March 30, 1959.

present bars to freer full-faith-and-credit borrowing. To a large extent, non-guaranteed debt has grown because it has offered the easiest way out of the dilemma.

While neglecting efforts to liberalize their borrowing power, the states in most cases have been reluctant to take either of two other steps which might bring a balance between receipts and expenditures. Despite periodical economy drives, budgets have continued to mount in response to public demand for new or expanded services.[2] And the states have been slow to act to obtain fresh tax money to offset the increased costs.

Failure of Revenues to Meet Budget Demands

The recession of 1957-58 severely tightened the squeeze on many of the states. Although total tax collections, according to preliminary Census Bureau estimates, rose 2.6 per cent from 1957 to 1958, the annual increase was the smallest of the postwar period in both dollar and percentage terms. Hard-hit industrial states like Michigan, Ohio, and Pennsylvania suffered declines in revenue from one or more of their principal taxes, and Pennsylvania was one of five states—the others were Connecticut, Iowa, Oregon, and Virginia—reporting over-all declines in tax yields.

Stringent economies were attempted in anticipation of the drop-off. The Tax Foundation, reporting March 4 on the 1959 budget picture, said: "Many governors cut department requests by 10 to 20 per cent to stem the tide, and the state legislatures are scrutinizing the executive budget for further areas in which they can trim." Despite added contributions to the federal interstate highway program, budgets proposed in 1958-59 averaged less than 10 per cent higher than those for the preceding budget periods. Increases in 1956-57 had run from 10 to 20 percent.

The economy effort, however, helped least where it mattered most. By and large, the states with the most acute revenue problems also had the most inflexible budgets. The recession swelled relief rolls in the industrial states and added heavily to the demand for other social services. According to figures filed with the Social Security Administration for all states except Idaho, state relief payments reached $29.9 million in December 1958, highest monthly

[2] Between 1946 and 1958 state outlays for hospitals and other health services rose 836 per cent, for higher education 450 per cent, for highways 799 per cent. In several categories of expenditure, highways in particular, the increases were attributable in part to the irresistible stimulus of federal grants-in-aid.

total since 1950. January 1959 payments were even higher, $31.9 million, with prospects of a continuing rise as additional workers exhausted unemployment compensation rights.

Estimates are that Indiana, Michigan, Minnesota, New Mexico, Ohio, Oregon, Pennsylvania, and West Virginia will all report declines in tax revenues at the end of fiscal 1959. Revenues of Alaska, Illinois, Maine, Missouri, Oklahoma, and Tennessee are expected to remain at about the fiscal 1958 level. Of these 14 states, only Maine, Michigan, and Ohio seem likely to hold spending at or below 1958 totals. Pennsylvania's expenditures, according to an estimate published by *Business Week* on Feb. 28, will rise approximately $170 million while tax revenues will slide off by $20 million to $25 million.

The combination of the recession and unwillingness to face up to the full implications of the pay-as-you-go approach has precipitated financial crises in a number of states. By most estimates, two-thirds to three-fourths of them are in some form of immediate financial trouble. Of the remainder, only a few—Mississippi and North Dakota are the leading examples—appear, for the time being at least, to be in fairly comfortable circumstances.

Recommendations for New or Increased Taxes

In 1959 to date, governors of 23 states have submitted recommendations for new taxes or increases in present taxes to raise a total of nearly $1.5 billion in additional revenue.[3] Some of the proposals are designed to affect or offend as few people as possible. Vermont, for example, is considering taxes on hotel and motel bills and on restaurant meals costing more than a dollar. Colorado is weighing a levy on trading stamps, Montana an impost on bowling fees. In a few states, however, governors have assumed the political risks inherent in requests for substantial general tax boosts.

The 23 governors seeking additional revenue[4] have proposed 11 new taxes and asked increased rates or a broad-

[3] Two limited sources of additional tax revenue were opened up for the states by Supreme Court rulings, Feb. 24, that the commerce clause of the Constitution is not violated by state taxation of (1) imported raw materials stored in the state for production use, or (2) business activities in the state of out-of-state corporations. While amounts cannot be estimated, fiscal experts doubt that revenue yields from these sources will be impressive.

[4] Information supplied by the Tax Foundation, Inc.

ened base for more than 50 existing levies. New taxes proposed include two on personal income (Michigan, Washington), two on corporate income (Michigan, Oregon), one on retail sales (Massachusetts), three on tobacco products (California, Pennsylvania, Vermont), two on severance of natural resources (California, Texas), and one on pari-mutuel betting (Washington).[5] Most of the proposals for higher rates or broadened tax bases involve personal income, retail sales, motor fuels, tobacco products, or alcoholic beverage levies.

Perhaps the most daring tax move, from a political standpoint, was that of Gov. Nelson A. Rockefeller, who told the New York legislature on Jan. 7:

> We must face the fact that our steadily rising population will, under the terms of state aid laws already in effect, result in constantly increasing state expenditures. The time is overdue for facing fiscal realities and making hard decisions. It is imperative that sufficient revenues be collected to meet the expenditures of state government. The constitution of the state makes a balanced budget mandatory, and the need for additional revenues is immediate.

The budget proposed by Rockefeller called for an increase of $240 million in state expenditures and an offsetting increase of $277 million in new tax revenues. The governor asked for and got a 2c boost in the gasoline tax. More than half of the new revenue was to come from the personal income tax, mostly through changes in exemptions. In place of existing exemptions of $1,000 for single taxpayers, $2,500 for married taxpayers, and $400 for each dependent, a flat exemption of $600 per person was proposed. New brackets were to be added to bring the maximum tax to 10 per cent on net income in excess of $15,000, in place of a top rate of 7 per cent on net income in excess of $9,000. Confronted by unanimous Democratic opposition, Rockefeller was forced by a group of Republican rebels to eliminate more than $40 million from his proposed budget and make several technical concessions in the tax table. However, the original proposals were diluted relatively little, and when the tax bill cleared the legislature in March, its passage was generally regarded as a major victory for the governor.

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[5] The proposed Pennsylvania and Vermont tobacco products tax, the Texas severance tax, the Oregon corporate income tax, and the Washington pari-mutuel tax, while classified as new levies, would actually be extensions of existing taxes to additional areas.

A $400 million tax package was submitted to the Pennsylvania legislature in March by Gov. David L. Lawrence. It included several levies of the marginal, limited-effect type, but called also for an increase in the sales tax from 3 to 3½ per cent and elimination of exemptions on a number of commodities and services.

POLITICAL IMPLICATIONS OF TAX BOOSTS IN STATES

The governors who have met the revenue problem head-on have tried so far as possible to limit the political hazards. A favorite tactic in states where there had been a shift in party control was to blame the need for new taxes on evasion of the problem by the preceding state administration. When there had been no change, the cumulative effects of recession and inflation usually were cited. In nearly every case such defenses had a considerable basis in fact, but they did not save the governors from sharp attack, often by members of their own party.

Although the political significance of taxation is universally recognized, this year's tax struggles are of more than ordinary interest—not only because of their probable influence on future state elections but also because of possible repercussions in the 1960 presidential race. The states where the budget problem is most acute and where the aftermath is likely to be most bitter—California, Massachusetts, Michigan, Minnesota, New York, Ohio, Pennsylvania, Washington, Wisconsin—among them control 202 of the 269 electoral votes which will be required to elect a president in 1960. All are closely contested "swing" states; all except New York now have Democratic governors. The tax battle might have a decisive effect on the political fortunes of such men as Rockefeller, Gov. Edmund G. Brown of California, and Gov. G. Mennen Williams of Michigan, all of whom have been mentioned as possible candidates for first or second place on the national tickets of their respective parties.

Notwithstanding the belief of some observers that a tax revolt is in the making, if not in progress, many of the governors who have ventured the direct approach have won considerable praise for personal political courage. How this may balance out in terms of support lost or support gained is problematical, but most political commentators agree that Rockefeller's clear-cut victory in the New York legislature materially enhanced his attraction as a presidential possibility.

Existing Tax Structures in the States

COLLECTIVELY, the 48 states in fiscal 1958[6] took in 99 per cent of their tax revenue from levies of six broad types: Sales (58.6 per cent), income (17.2 per cent), licenses (14.7 per cent), property (3.6 per cent), severance (2.5 per cent), death and gift (2.4 per cent). Counting separately certain sub-types of sales, income, and license taxes, more than 94 per cent of combined state tax revenue was derived from 13 specific levies. Of these, the most productive were the general sales or gross receipts tax and the motor fuels tax. The proportion of total state tax revenue produced by each of the various levies is shown below.

PROPORTIONATE YIELD OF VARIOUS STATE TAXES, 1958

Tax	% of total state tax revenue	Tax	% of total state tax revenue
General sales or gross receipts	23.5	Alcoholic beverages	3.8
Motor fuels	19.6	Property	3.6
Personal income	10.6	Insurance sales	3.1
Motor vehicle and operator license	9.5	Corporation license	2.8
Corporation income	6.6	Severance	2.5
Tobacco products	4.1	Death and gift	2.4
		Public utility sales	2.3
		Others	5.6

Tax structures of the individual states show marked variations from the composite pattern. Of the 33 states which impose a general sales or gross receipts tax, only Maryland, North Carolina, Oklahoma, Louisiana and Pennsylvania collect from it less than the general average of 23.5 per cent of total tax revenue; most of the other 28 states levying the tax depend on that source for about one-third of the total tax take (Washington and West Virginia for more than one-half). Nine states collect 75 per cent or more of total tax receipts from sales taxes of various kinds, including a general sales tax; five states, none of which levies a general sales tax, take in 35 per cent or less of total tax revenue from other forms of sales levies.[7] Thirty states receive 75 per cent or more of the tax total

[6] Alaska, which did not become a state until last Jan. 3, midway in the fiscal year 1959, will be included in the Census Bureau's state tax collection report for that year. Hawaii is expected to be included for the first time in the report for fiscal 1960.

[7] The nine states are Florida, Georgia, Illinois, Indiana, Maine, Nevada, South Dakota, Washington, West Virginia. The five states are Delaware, Minnesota, New York, Oregon, Wisconsin; Alaska also was in the latter group in 1957.

from sales levies plus one other type of tax, usually a license tax. West Virginia is the extreme case at 98 per cent, with Illinois close behind at 97.2 per cent.

Collections in other tax categories also vary widely among different states. License tax receipts range from 34.9 per cent of the total in New Jersey down to 6.8 per cent in Georgia. In the 32 states[8] imposing some form of personal income tax, receipts constitute 43.8 per cent of the total tax yield in Oregon but only 1.7 per cent in Tennessee. The variation in the case of corporate income tax revenue runs from 17.2 per cent in New York down to 0.6 per cent in South Dakota.[9] The property tax brings in 29.3 per cent of all tax revenues in Nebraska, but less than five-hundredths of 1 per cent in Connecticut and Oregon. The range of death and gift tax receipts is from 6.4 per cent in New Jersey to two-tenths of 1 per cent in Alabama and Arizona, and for severance levies from 27.3 per cent in Texas and 20.6 per cent in Louisiana to virtually nothing in Florida and Missouri.

Several states receive substantial revenue from one or more other taxes. The pari-mutuels tax—classed among sales and gross receipts taxes in the Census Bureau's reporting system—brings in a million dollars or more in most of the 24 states which impose it. Collections top 5 per cent of the total in Florida, New Hampshire, and New Jersey and are of nearly that magnitude in New York. Nevada gets 19.9 per cent of its total tax revenue from a gambling tax.

Most states derive anywhere from a fraction up to 2 or 3 per cent of their tax receipts from sales levies on such commodities as soft drinks and on various forms of amusement—from pin ball machines to athletic events. Chain store taxes are a fairly lucrative source of revenue in some of the 14 states which impose them. Twenty-two states levy no taxes outside the six major categories. Of those that do, the only ones which receive more than 1 per cent of the total tax take from the other sources are Alaska, Florida, Michigan, Nebraska, New Hampshire, New York, Pennsylvania, Vermont, and Virginia. Michigan's "value-added" tax, the only one of its type, brings in 7.6 per cent of the state's total tax revenue, nearly twice the ratio for

[8] Including Alaska.

[9] The South Dakota tax applies only to financial institutions.

State Use of Major Tax Sources

(Note: All states have motor vehicle and corporate license taxes. Excises on motor fuels, alcoholic beverages, and insurance receipts are applied in all states in one form or another.)

State	General Sales and/or Gross Receipts Taxes	Personal Income Tax	Corporate Income Tax	Property Taxes (State) General or Special	Tobacco Sales Tax	Inheritance and/or Estate Taxes	Severance Taxes	Pari-mutuels Tax
Ala.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	--
Alaska	--	Yes	Yes	--	Yes	Yes	Yes	--
Ariz.	Yes	Yes	Yes	Yes	Yes	Yes	--	Yes
Ark.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Calif.	Yes	Yes	Yes	Yes	--	Yes	Yes	Yes
Colo.	Yes	Yes	Yes	Yes	--	Yes	Yes	Yes
Conn.	Yes	--	Yes	Yes	Yes	Yes	--	--
Del.	--	Yes	Yes	Yes	Yes	Yes	--	Yes
Fla.	Yes	--	--	Yes	Yes	Yes	Yes	Yes
Ga.	Yes	Yes	Yes	Yes	Yes	Yes	--	--
Idaho	--	Yes	Yes	Yes	Yes	Yes	Yes	--
Ill.	Yes	--	--	Yes	Yes	Yes	--	Yes
Ind.	Yes	--	--	Yes	Yes	Yes	Yes	--
Iowa	Yes	Yes	Yes	Yes	Yes	Yes	--	--
Kan.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	--
Ky.	--	Yes	Yes	Yes	Yes	Yes	Yes	Yes
La.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Maine	Yes	--	--	Yes	Yes	Yes	--	Yes
Md.	Yes	Yes	Yes	Yes	Yes	Yes	--	Yes
Mass.	--	Yes	Yes	Yes	Yes	Yes	--	Yes
Mich.	Yes	--	--	Yes	Yes	Yes	Yes	Yes
Minn.	--	Yes	Yes	Yes	Yes	Yes	Yes	--
Miss.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	--
Mo.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	--
Mont.	--	Yes	Yes	Yes	Yes	Yes	Yes	--
Neb.	--	--	--	Yes	Yes	Yes	Yes	--
Nev.	Yes	--	--	Yes	Yes	--	Yes	Yes
N. H.	--	Yes†	--	Yes	Yes	Yes	Yes	Yes
N. J.	--	--	Yes	Yes	Yes	Yes	--	Yes
N. M.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N. Y.	--	Yes	Yes	Yes	Yes	Yes	--	Yes
N. C.	Yes	Yes	Yes	Yes	--	Yes	--	--
N. D.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	--
Ohio	Yes	--	--	Yes	Yes	Yes	--	Yes
Okla.	Yes	Yes	Yes	--	Yes	Yes	Yes	--
Ore.	--	Yes	Yes	Yes	--	Yes	Yes	Yes
Pa.	Yes	--	Yes	Yes	Yes	Yes	--	--
R. I.	Yes	--	Yes	--	Yes	Yes	--	Yes
S. C.	Yes	Yes	Yes	Yes	Yes	Yes	--	--
S. D.	Yes	--	‡	Yes	Yes	Yes	Yes	Yes
Tenn.	Yes	Yes†	Yes	--	Yes	Yes	--	--
Texas	--	--	--	Yes	Yes	Yes	Yes	--
Utah	Yes	Yes	Yes	Yes	Yes	Yes	Yes	--
Vt.	--	Yes	Yes	Yes	Yes	Yes	--	--
Va.	--	Yes	Yes	Yes	--	Yes	Yes	--
Wash.	Yes	--	--	Yes	Yes	Yes	--	Yes
W. Va.	Yes	--	--	Yes	Yes	Yes	--	Yes
Wis.	--	Yes	Yes	Yes	Yes	Yes	Yes	--
Wyo.	Yes	--	--	Yes	Yes	Yes	--	--
TOTAL	33	32	35	45	44	48	28	24

†*Intangibles only.* ‡*Banks only.*

any of the other unclassified taxes, which include documentary, stock transfer, and head or poll taxes.

Variations in Application of Major State Taxes

The primary reason for the wide variation in distribution of revenue sources from state to state is simply the existence or absence of particular forms of taxation. Some authorities say that all taxes can be fitted into one of three classes, depending on the base employed—income, property, or consumption. In general, eliminating from consideration the taxes which are in effect in all states, it can be said that the overwhelming majority of states are basically committed either to income or consumption taxation.[10] Although the general sales tax is applied in 33 states and the personal income and corporate income taxes in 32 states and 35 states, respectively, most states are in either one camp or the other, as the table opposite shows.

Actually, the table understates the situation. Because the productivity of some taxes is limited by restriction of the area of application or by low rates or high exemptions, only a handful of the general sales tax states—Colorado, Maryland, North Carolina, Utah—received as much as 20 per cent of the tax total from their personal and corporate income taxes in 1958.[11] The income-oriented states, on the other hand, generally took in 30 to more than 50 per cent of their tax total from individual and corporate levies.

Among the states which impose general sales taxes, the usual practice is to tax retail sales and the use of items brought in from outside the state. Rates are about equally divided between 2 and 3 per cent, with Washington's 3.33 per cent the only variant. Arizona's tax applies to wholesale sales, and to extractive and manufacturing industries, as well as to retail sales. Mississippi's gross receipts tax includes personal and professional services; Washington also taxes personal and professional services, but at a reduced rate of 0.4 per cent. Indiana levies a gross income tax at 0.375 per cent which covers all the above categories plus receipts from wages, salaries, rents, interest, and dividends. Although the Indiana tax has some of the characteristics of a non-progressive income tax, including a fam-

[10] Only Arizona, Nebraska, and Wyoming continue to depend to an important extent on property taxes. The tendency has been to surrender this source of revenue almost entirely to local governments.

[11] A 1 per cent increase in Maryland's general sales tax, which went into effect last Jan. 1, will probably eliminate that state from the group.

ily exemption, most authorities consider it a variety of sales tax. West Virginia levies a similar tax in addition to its retail sales tax.

The principal selective sales taxes, often called excises, are applied almost universally. All 49 states have motor fuel taxes at rates varying from 3c a gallon in Missouri to 7c in nearly a dozen states; 6c to 7c is usual. Diesel fuel is more heavily taxed in a number of states. Some form of alcoholic beverage tax also is imposed in every state, including the constitutionally dry states of Mississippi and Oklahoma where the tax is limited to malt beverages. Most of the 17 states in which liquor retailing is a state monopoly also limit the alcohol tax to malt beverages and collect on spirits and wine through the mark-up over wholesale prices. Vermont, though a monopoly state, collects a tax of $5.10 over and above its mark-up on each gallon of distilled spirits sold; Alabama, another monopoly state, collects a 20 per cent tax on the retail price. At the other extreme, Missouri and Nevada, both non-monopoly states, levy a tax of only 80c a gallon. Wines are taxed by alcoholic content at much lower rates than spirits, beer generally at still lower rates.

Cigarette taxes in the 44 states which collect them range from a low of 2c a pack in Arizona and Missouri to a high of 8c a pack in Louisiana and Montana, with the average at about 5c. Cigars are taxed in only nine states, smoking and chewing tobacco in eight states each.

Income taxes in most states are only mildly progressive and in many cases allow such liberal exemptions and deductions that they impose only a slight burden on the taxpayer. North Dakota's tax is the most steeply graduated, rising from 1 per cent on net taxable income of $3,000 to 11 per cent on income in excess of $15,000. New Mexico, on the other hand, collects only 1 per cent on net income up to $10,000 and 4 per cent on income in excess of $100,000. Maryland, Massachusetts, New Hampshire, and Tennessee levy the tax at a flat rate.[12] Mississippi grants an exemption of $4,000 to a single taxpayer and $6,000 to a family head. The Minnesota law, which provides for a credit against the tax due rather than for an exemption, allows three times as much to a married person as to a single taxpayer.

[12] New Hampshire and Tennessee tax only dividend and interest income.

The income tax picture is complicated by the fact that 20 states allow some form of deduction on account of income tax payments to the federal government, which in turn allows a taxpayer to deduct state income tax payments in preparing his federal return. Effects of this double deductibility are especially striking in the upper income brackets, where the actual burden of the state levy may be reduced to a fraction of the stated rate. A report to a U.S. Senate committee in 1943 estimated that a 15 per cent state income tax on an individual with income in the top federal bracket would amount to an effective state tax of only 0.1 per cent where double deductions were allowed.[13] Lax enforcement in a number of states makes it easy to evade tax obligations. With Massachusetts and New York newly recruited to the list, only 15 states[14] regularly withhold taxes on wages and salaries of resident taxpayers.

State corporate income tax rates are no more progressive than the rates on individual income; in fact, only in six states—Arizona, Arkansas, Kentucky, Mississippi, North Dakota, Wisconsin—are the corporate rates graduated. Rates range from 2 per cent in Iowa, Montana, and New Mexico to 8.8 per cent in Idaho. Double corporate tax deductibility prevails in 16 states.

Increasing Reliance on Sales and Income Taxes

The majority of states have tended increasingly to rely on the general sales tax to meet revenue needs. Ten states have imposed the tax since World War II, and most of the others have either increased rates or reduced the list of exempted commodities, often both. General sales taxes brought in only 15.1 per cent of all state tax revenue in 1940 but now account for 23.5 per cent. Individual and corporate income taxes also are relatively more important than they were two decades ago, in part because of rate increases but more directly because of the over-all rise in personal income.

Until two years ago, the only state income tax introduced during the postwar period had been a levy on corporate income adopted by Rhode Island in 1947. However, the ever-widening search for fresh revenue sources has now led to a revival of interest in the income tax. Dela-

[13] At present, no state income tax carries a maximum rate as high as 15 per cent.

[14] Including Alaska, Indiana (gross income tax), and Utah (as of July 1, 1959). Hawaii also withholds income taxes.

ware in 1957 added a tax on corporate income to its existing tax on individual income. New Jersey adopted a corporate income tax in 1958.

The oft-noted decline in the importance of state property taxes has continued into the postwar period, but the largest part of the percentage drop took place before the 1930s. Cash collections have actually risen from $260 million in 1940 to $533 million in 1958, largely as a result of increases in assessments to take account of price inflation during the war and postwar periods.

Regressive Character of State Tax Structures

Reliance on consumption taxes and the relatively slight degree of progression in state income tax structures have resulted in an aggregate state tax burden which bears most heavily on those least able to pay. Using statistics for 1954, Richard A. Musgrave of the University of Michigan estimated for the congressional Joint Committee on the Economic Report that effective state-local tax rates amounted to 11.2 per cent for persons with incomes of less than $2,000 but to only 7.7 per cent for persons with incomes of more than $10,000.[15] A quite opposite situation prevails in the case of federal taxes. Despite growing importance of federal excises, effective rates of federal taxes in 1954, Musgrave said, amounted to 15.7 per cent for persons with incomes of less than $2,000 and to 33.2 per cent for persons with incomes of $10,000 or more.

The effect for state taxpayers is compounded by the fact, not generally recognized, that the tax burden on the whole is heaviest, not in states richest in terms of personal income, but in the middle and lower income states. Thus a recent Census Bureau report disclosed that Mississippi, bottom state in per capita income, stands second in state-local tax revenue collected per $1,000 of personal income. North Dakota, where revenue collections per $1,000 of personal income are largest, ranks 41st in per capita income.[16] At the other end of the scale, Connecticut is first in per capita income and 42nd in tax burden as measured by levies on that income; Delaware, second in per capita income, bears the lightest tax burden.

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[15] Richard A. Musgrave, "The Incidence of the Tax Structure and the Effects on Consumption," in *Federal Tax Policy for Economic Growth and Stability* (1955), p. 98.

[16] Bureau of the Census, *State and Local Government Finances in 1957* (February 1959), p. 17.

The regressive character of state taxation has been a continuing target of labor organizations and many economists. A number of governors also have entered the fray. Limited regression is defended by some, however, on two grounds: First, that the over-all tax pattern, including federal taxes, remains progressive; second, that "In an economy such as ours, incomes generally are large enough that some regressivity in a tax need be of little concern if the tax has a high ranking on other grounds." [17] In any case, state legislatures have refused to back away from taxes on consumption, although they have frequently exempted foods and drugs from sales taxes.[18]

Regression in state tax systems accounts in part for the fact that certain groups direct their political activities mainly to Washington rather than to the state capitals. Referring to Musgrave's findings, the A.F.L.-C.I.O. declared: "These facts shed a revealing light on the motivation of the states' rights movement. A dollar of tax income raised by a state or local government is much less costly for the wealthy than the dollar raised by Uncle Sam." [19]

Obstacles to Tax and Fiscal Reform in States

Not all of the states could levy a progressive income tax if they so desired. Such a tax has been ruled unconstitutional in Illinois, Pennsylvania, and Washington. Indiana imposes a gross income tax but has avoided levying a progressive income tax, partly in the belief that it would be nullified by the courts.

Debt limitations, constitutional and statutory earmarking of revenues, and wide intrastate variations in property assessment practices are other factors which, in one way or another, have stood in the way of state tax reform and at the same time contributed to pressure for expansion of federal instead of state activities.

According to the latest information available,[20] the power to borrow freely by majority vote of the legislature is avail-

[17] O. H. Brownlee, "Sales Taxes and Income Taxes," *Farm Policy Forum* (Vol. II, No. 2, 1958-59), p. 17.

[18] Nine states exempt all food products; seven others exempt farm products sold directly to the consumer.

[19] A.F.L.-C.I.O., *State and Local Taxes: A Handbook on Problems and Solutions* (1958), p. 13.

[20] Tax Foundation, Inc., *Constitutional Debt Control in the States* (1954), p. 13.

able in only five states—Connecticut, Mississippi, New Hampshire, Tennessee, and Vermont. Legislatures in Delaware, Maryland, and Massachusetts are subject to procedural limitations—a three-fourths vote by each house in Delaware. All of the remaining states need either a constitutional amendment or a popular referendum to borrow more than a specified maximum sum, $50,000 to $2 million, allowed to cover temporary deficits. Arkansas, Florida, and New York permit no borrowing at all without approval of the voters.

These limitations apply only to guaranteed debt (backed by the full faith and credit of the state). As taxpayer resistance has stiffened, the states have turned increasingly to non-guaranteed, revenue-secured debt to provide for such needs as new highways and dormitories at state universities. Non-guaranteed debt climbed from $358 million in 1946 to $7.7 billion in 1958, an increase of 2,051 per cent. Fifty-one per cent of all state long-term debt is now non-guaranteed compared to 15.4 per cent in 1946.

Although the pros and cons of constitutional debt limitations are subject to hot debate, fiscal authorities on both sides of the argument seem agreed that the rapid growth of non-guaranteed debt has made it harder for the states to exercise effective budgetary control. Even more serious in this respect, however, is the all but universal practice of earmarking. In the latest year for which information is available, 51.3 per cent of all state tax revenues were earmarked, either constitutionally or by statute, for specified purposes.[21] So-called highway user funds received the bulk of the earmarked revenue, but education and welfare programs also were important beneficiaries. Led by Utah, which in 1955 returned all sales and use tax collections to the general fund, several states have recently voided earmarking arrangements. However, Delaware, the only state which had no earmarking whatever in 1954, now has a special arrangement for roads. At the extreme, 89 per cent of all Alabama tax revenue was earmarked in fiscal 1954.

Fixed expenditures chargeable to the general fund are another form of commitment which gives concern to numerous fiscal policy experts. Such mandated spending accounts in many states for 25 per cent or more of the total budget.

[21] Tax Foundation, Inc., *Earmarked State Taxes* (1955), p. 13.

Taken collectively, earmarking and fixed expenditures remove nearly three-fourths of all spending from legislative control in fully one-third of the states.

The tax situation is further complicated by local assessment practices which tend, in a large majority of the states, to value urban residential property at much higher levels than farm property.[22] While the declining importance of state property taxes might seem to eliminate assessment as a significant factor, assessed valuation in most states is one of the elements used in computing the amount of state aid to be paid to local governments. Coupled with earmarking, which leaves the legislatures little or no room for maneuver in response to special needs, the assessment system—in spite of all efforts to develop equalizing formulas—gives urban areas another reason to look to Washington for relief.[23]

Long-Range Pressures on State Budgets

BARRING American participation in a new world war, virtually all experts on financial problems of the states are agreed that more money will have to be raised and spent by the states in the years ahead than is being raised and spent at the present time. The Tax Foundation estimated in 1955 that state and local governments combined would be spending $56.6 billion in 1965. However, the total probably will come close to that figure in 1959, six years in advance of schedule. Commenting on its earlier estimate, the Tax Foundation said in March 1958: "It may be concluded that even on the most conservative assumptions about future demands for services, expenditures of state and local governments are likely to rise more rapidly than total national output."

Some of the reasons are readily apparent. Population is growing at a rate of about three million a year. The proportions of school children and elderly are increasing.

[22] Bureau of the Census, *Assessed Values and Sales Prices of Transferred Real Property* (May 5, 1958). Farm property was assessed at higher rates in nine states and at about the same rate in Wyoming. However, in Arizona and Florida the ratio was almost 4 to 1 to the disadvantage of urban residential property, and in eight additional states there was an almost 2-to-1 ratio of the same sort.

[23] See "Unequal Representation," *E.R.R.*, 1958 Vol. II, pp. 813-832.

Motor vehicle registrations are climbing. The capital construction backlog is still enormous; the U.S. Commerce Department in 1955 put state-local capital construction needs at $204 billion for the 1955-1964 period.

The toll taken by inflation also is generally recognized. Less widely understood, however, is the fact that inflation has borne more heavily on state and local governments than on the consumer at large. According to Department of Commerce calculations on the basis of 1954 dollars, inflation took a bite of about 28 per cent out of the average consumer's dollar between 1946 and 1957, but the state-local government dollar declined nearly 50 per cent in purchasing power during the same period.

Another central factor in the long-term rise of state spending is the steady expansion of federal aid, particularly since the passage of the Highway Act of 1956 setting up the federal interstate network. Total federal payments to state and local governments are expected to reach $7.1 billion in fiscal 1960; they stood at $2.3 billion as recently as 1950. Most of this money comes in the form of grants-in-aid which require matching contributions. Even the 10 per cent outlay stipulated in the highway program can mount up fast. Payments out of the highway trust fund will top $3 billion in fiscal 1960.

Proposals for Shifting Federal-State Functions

Proposals to eliminate some of the federal grants-in-aid programs have been endorsed at the White House. Addressing the Governors' Conference in Williamsburg, Va., on June 24, 1957, President Eisenhower called for creation of a study group:

> One—to designate functions which the states are ready and willing to assume and finance that are now performed or financed wholly or in part by the federal government; two—to recommend the federal and state revenue adjustments required to enable the states to assume such functions; and three—to identify functions and responsibilities likely to require state or federal attention in the future and to recommend the level of state effort, or federal effort, or both, that will be needed to assure effective action.

The Joint Federal-State Action Committee, appointed to carry out the President's suggestions, recommended on Dec. 6, 1957, that the states assume sole responsibility for four programs currently costing the federal government about $105 million a year—vocational education, construc-

tion of waste treatment facilities, urban renewal planning, and repair of public facilities damaged in natural disasters. It proposed that the federal government in return reduce the tax on local telephone service for five years from 10 to 6 per cent in states levying a like 4 per cent tax of their own.[24] At the end of the five-year period, the federal tax would be reduced throughout the country to 6 per cent and the states would be entirely on their own.

The proposals were received without enthusiasm in Congress. Critics pointed out that the plan failed to consider the differing financial capacities of the states. To meet this objection, the Federal-State Action Committee on Sept. 9, 1958, put forward a revised plan calling for maintenance of the federal telephone tax at 7 per cent during the five-year transition period, with the extra penny-on-a-dollar to be divided among 31 lower income states. As in the original plan, the federal tax would be reduced to 6 per cent at the end of five years.

The committee is in the first stages of developing proposals to increase the state yield from death taxes. Under the present system, death taxes paid to the states are credited against the amount due the federal government in a ratio equivalent to 80 per cent of the estate tax payable under rates imposed by a 1926 law. Since 1926, exemptions from the federal estate tax have been lowered and the rates of the tax more than trebled; in practice, therefore, the so-called "80 per cent credit" works out to about 10 per cent of the present gross federal tax. The credit system, however, was effective in encouraging state utilization of death taxes. All states except Nevada now levy some form of estate or inheritance tax to ensure full absorption of the federal credit. Yet most fiscal authorities think that the state taxes could be made considerably more productive through narrowing of exemptions and plugging of loopholes.

Opposition to State Assumption of Added Tasks

Although there is widespread sympathy in and out of Congress for the financial plight of the states, the move to turn back programs and tax resources has generated much more opposition than support. Urban groups like the American Municipal Association and the U.S. Confer-

[24] Revenue to the states, if all imposed the 4 per cent tax, was estimated at $148 million.

ence of Mayors have condemned the over-all approach of the Joint Federal-State Action Committee, and sources close to the committee say that even some of the governors themselves have shown slight interest in attempts to make far-reaching changes in the current balance between state and federal activities. As a result, the committee has been something of a disappointment to fiscal conservatives who hoped that it might successfully promote a restoration of state powers in effect defaulted to the central government.

Reasons for the cool response to the committee's efforts are not difficult to find. The regressive character of state tax structures, the dominance of rural majorities in most state legislatures, the various constitutional and statutory restrictions on financing have convinced many city law-makers that they can get more from Washington than from their own state capitals.

Persons sympathetic to the states' rights movement have been stressing these points with increasing urgency in recent years. Noting "the extent of the animosity shown toward state government by city officials," a House subcommittee studying federal-state-local relations said in a report on Aug. 8, 1958:

> Taken as a whole . . . state-local relationships are an important determinant of federal grant policies. So long as the cities are deprived by state restrictions of the opportunity to solve local problems and are denied a fair voice in the determination of local legislative policies, they will continue to seek federal assistance and will attempt to bypass the states through direct federal-local arrangements.

State aid to local governments has gone up sharply since World War II, rising from $2.1 billion in 1946 to $8 billion in 1958. But relatively little of this money has gone to the urban areas which pay the bulk of the taxes. In 1957, school districts received 38 per cent of all their revenues from the state, and counties received 35 per cent. Cities, on the other hand, got only 12½ per cent of their funds from the state. In view of this situation, the Tax Foundation warned in March 1958 that the states would have to "provide greater assistance to [their] larger municipalities . . . unless they are willing to see the predominant contributors of state taxes turn to the federal government for aid." [25]

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[25] Tax Foundation, Inc., *The Financial Challenge to the States* (1958), p. 26. See "Metropolitan Areas and the Federal Government," *E.R.R.*, 1959 Vol. I, pp. 41-58.